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Hong Kong

Market Development Reports

Closer Economic Partnership Arrangement 2003

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Report Highlights:

Hong Kong and Mainland China signed the Closer Economic Partnership Agreement (CEPA) on June 29, 2003. The agreement covers three main areas: trade in goods, trade in services, and trade and investment facilitation. Nearly 300 product categories have been selected for tariff elimination on January 1, 2004. The essence of CEPA is to allow Hong Kong goods and companies to have earlier or better access to the China market. The trend of further economic integration between Hong Kong and China has gathered full momentum after the signing of CEPA. U.S. exporters are encouraged to look into the agreement and evaluate how they may capture the new opportunities arising from CEPA.

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Summary

Hong Kong and Mainland China signed the Closer Economic Partnership Arrangement (CEPA) on June 29, 2003. The agreement covers three main areas: trade in goods, trade in services, and trade and investment facilitation. The essence of CEPA is to allow Hong Kong goods and companies to have earlier or better access to the China market than contained in China's commitments under World Trade Organization (WTO). Since Hong Kong does not impose duties on most of its imports, the arrangement is actually quite one-sided, as admitted by Hong Kong's trade minister. CEPA, therefore, is generally considered as a gift that Mainland China is offering to Hong Kong out of political considerations to boost the latter's economy. It also serves as a catalyst for further economic integration for the betterment of the whole Pearl River Delta region on both sides of the border.

CEPA touches many areas, and the concessions to Hong Kong goods and services vary according to different sectors. Implementation details of many provisions have not yet been finalized. While the agreement has extensive ramifications, this report tries to look into CEPA in the context of the potential impact on the food and agricultural sectors. Hong Kong is a free economy and is keen to attract foreign investment. Import regulations are transparent and consistent. In 2002, Hong Kong imported US\$10 billion of agricultural and food products, US\$1.56 billion of which or 15 percent came from the United States. U.S. food exporters may explore new opportunities arising from CEPA.

Background

The idea of a free trade agreement with Mainland China first emerged in a Hong Kong General Chamber of Commerce proposal at the start of 2001. Acknowledging that a free trade agreement would boost Hong Kong's economy, the government initiated dialogue with Mainland China on this topic. In December 2001, the Hong Kong government obtained China's approval in principle on Hong Kong's proposal as to the establishment of a free trade area. Formal discussions were then launched in January 2002, and the proposal has been named as CEPA. The Hong Kong government claimed that both sides agreed the CEPA consultations should comply with WTO and with the "One country, Two systems" principle.

Intensive negotiation over CEPA between the two governments continued over one year and the agreement was finally signed in June encompassing three major areas: trade in goods, trade in services and trade and investment facilitation. Further discussions will continue between the two governments to work out implementation details such as the definition of country of origin. The liberalization measures will formally come into force on January 1, 2004.

Trade in Goods

On trade in goods, the Mainland has agreed to apply zero import tariffs from January 1, 2004 for Hong Kong exports meeting the CEPA origin requirements and being under one of 273 Mainland product codes. The Mainland has also agreed to apply additional zero import tariffs by January 1, 2006 upon application by local manufacturers for other codes maintained on China's tariff system and meeting the CEPA rules of origin.

Under the WTO, China is committed to reduce import tariffs, and average final bound rate will fall to about 10% for all products. Under the WTO, Hong Kong's domestic exports to the Mainland are subject to tariffs at the same rates as goods from all other WTO members in the absence of CEPA. With the conclusion of CEPA, 273 product categories will enjoy zero tariff as early as January 1, 2004. The Hong Kong government estimated that Hong Kong companies can save HK\$750 million (US\$96 million) worth of tariff annually resulting from

the zero tariff treatment applied on the 273 product categories, which cover about 60 percent of Hong Kong's domestic exports to China. As a result of this concession and China's commitments upon accession to the WTO, about 90 percent of the value of Hong Kong's domestic exports to China will enjoy zero tariffs by January 2004. The remaining 10 percent covering about 2000 product categories are expected to be treated with tariff free status before 2006.

CEPA will benefit Hong Kong products exporting to Mainland China considering that China's WTO bound rate averages 10%. However, the two sides have yet to agree to the definition of Hong Kong origin and are planning to reach a consensus before the end of 2003. The definition will probably be fairly strict. A Mainland official commented that an added value of 20 percent would be too lax for a Hong Kong origin definition. Since Hong Kong has relocated many manufacturing processes offshore in the past two decades and relies on imports for most raw materials, too high an added value to fulfill the country of origin requirements will spoil the spirit of CEPA. Therefore, many business representatives/associations are submitting their suggestions to the Hong Kong government for consideration.

Agricultural products are mostly not included in the first tranche of tariff elimination. The 273 product codes which are subject to zero tariff by January 1, 2004 cover electrical and electronics products, plastic articles, paper articles, textile and clothing, chemical products, pharmaceutical products, clocks and watches, jewellery, cosmetics, metal products, etc. There are only two product categories which are of relevance to U.S. agricultural and food exporters: ice cream (HScode 21050000, ice cream and other edible ice), and cotton value added products including yarn, fabric and apparels.

According to CEPA, ice cream products fulfilling Hong Kong's origin definition are eligible to be exported to Mainland China tariff free. On the other hand, ice cream products manufactured somewhere else are subject to a 24.2% duty which is the mainland 2003 MFN tariff rate for ice cream. The WTO bound rate is 19%. Though Hong Kong has a very sophisticated investment environment, it has high labor costs and land costs. U.S. companies need to evaluate whether the savings in tariffs can outbalance the production cost in Hong Kong. The elimination of tariff for exports to China certainly adds to the merits of Hong Kong being a manufacturing base.

There may be a benefit for U.S. cotton in CEPA. As a result of the CEPA arrangement, Hong Kong cotton yarns will become more competitive when their goods are exported to China. Currently China's tariff rate for cotton yarn and cotton fabric exports from Hong Kong is 5% and 10% - 11.8% respectively. Import tariffs mean Hong Kong goods can hardly compete with China's domestic supplies. Effective January 1, 2004, however, these products fulfilling the to-be-determined origin requirements can be exported to China tariff free. Hong Kong's competitive edge will be greatly enhanced. Consequently, according to trade sources, the better sales prospect for cotton yarns and fabric in China will enhance a greater demand for cotton in Hong Kong. Hong Kong imported over US\$63 million of U.S. cotton in 2002 and ranked 13th for U.S. cotton exports. The United States is the largest cotton supplier to Hong Kong. Any positive impact on Hong Kong's cotton demand would benefit U.S. exports.

There are limited agricultural and food items included in the list of 273 product codes, but the Mainland has agreed to apply zero import tariffs latest by January 1, 2006 upon application by Hong Kong manufacturers for other codes maintained on China's tariff system. Many Hong Kong companies are interested in opening restaurant chains that will require food imports. Yet, it is not clear whether applications for zero tariff treatment made after January 1, 2006 will be approved by China.

Trade in Services

On trade in services, 17 sectors will benefit in terms of additional market access or removal of specific restrictions in the Mainland market. They include management consultant services, exhibitions and conventions, advertising, legal services, accounting services, medical and dental services, real estate and construction services, transport services, distribution, logistics, forwarding services, storage services, tourism, audiovisual, banking, securities and insurance.

Broadly speaking, CEPA allows Hong Kong companies and services providers earlier access to the China market, ahead of China's WTO timetable. The definition of "Hong Kong company" has been confirmed and varies according to different sectors. In general, companies which register in Hong Kong, pay profits tax, open their offices in Hong Kong and hire over 50 percent of their staff in Hong Kong will be able to enjoy the privileges of CEPA. Also, the business nature in the Mainland must be the same in Hong Kong. Companies need to be in Hong Kong for at least three years except that a five-year requirement is set for banks, insurance companies and construction firms.

Distribution

The new opportunities for Hong Kong companies to participate in transport and distribution on the Mainland will lead to better access for imported foods. The 17 service sectors have different privileges specific to its particular sector under CEPA. In the case of distribution, U.S. food and agricultural products distributed/represented by Hong Kong companies can benefit from market liberalization measures provided by CEPA. (According to the released CEPA information, there are no conditions attached to the products being represented by Hong Kong companies). Through Hong Kong companies being a middleman, U.S. food/agricultural products can have better access to the China market. The Hong Kong government has compared China's commitment between CEPA and WTO and concluded the following:

- 1 Hong Kong enterprises are permitted to supply distribution services (including commission agents, wholesale, retail and franchising) in the Mainland on a wholly-owned basis, and to set up wholly-owned external trading companies, one year ahead of China WTO's timetable. Hong Kong enterprises can set up retailing companies in all cities at the prefectural level in the Mainland, and cities at the county level in Guangdong Province (a province in the south).
- 2 The entry requirements for Hong Kong services suppliers to set up external trading companies, wholesale commercial enterprises or retailing commercial enterprises in Mainland are lowered. For example, for setting up a wholesale commercial enterprise, the minimum average annual sales value in the previous 3 years is lowered from the current requirement of US\$2.5 billion to US\$30 million, and that for setting up a retail commercial enterprise is lowered from the current requirement of US\$2 billion to US\$100 million.

Tourism Services

CEPA provides liberalization measures for hotels and restaurants. Hong Kong companies are permitted to operate restaurant establishments in the Mainland on a wholly-owned basis. There are two implications for U.S. exporters. First, many Hong Kong companies import U.S. food products. Their operations in China will lead to increased demand for U.S. products.

Secondly, Hong Kong companies envisage that their operation of restaurant businesses in Mainland China requires food imports. The profit margin will be hampered if their food imports are subject to tariffs. In this connection, they have been lobbying the Hong Kong government to include more food items to enjoy zero tariff treatment and to have a country of origin definition based on manufacturing processes instead of content. Since Hong Kong relies on imports of raw materials, a country of origin definition based on content will make many "Hong Kong made products" fail to pass the CEPA origin requirements. Consequently, many products cannot be imported to China tariff free.

If Hong Kong companies succeed to obtain zero tariff treatment for more food imports to China, Hong Kong will have the possibility to strengthen its food manufacturing businesses. This then creates a demand for food ingredients providing opportunities for U.S. exporters.

Trade and Investment Facilitation

With regard to trade and investment facilitation, both sides agree on promoting cooperation in seven areas, namely, customs clearance; quarantine and inspection of commodities, quality assurance and food safety; small and medium-sized enterprises; Chinese medicine and medical products; electronic commerce; trade and investment promotion; and transparency in law and regulations.

In the areas of customs clearance facilitation, the Mainland China and Hong Kong will establish a customs information exchange system. They will explore the feasibility of data networking and the development of electronic customs clearance at control points. For quarantine and inspection of commodities, and food safety, both sides will strengthen cooperation by looking into areas such as sanitary and phytosanitary measures, product certification and accreditation, etc.

Such measures raise concerns whether Hong Kong will be able to maintain its status as a separate customs territory with its own set of import requirements. Currently Hong Kong has its own import regulations with certification, sanitary and phytosanitary requirements different from China. The existing import requirements are consistent and transparent. It is worth noting the impact of CEPA on Hong Kong's future import regulations. Will trade facilitation measures between Hong Kong and China result in compromises on standards and import requirements? Will data networking which is an attempt to facilitate customs clearance result in sharing of data? There are no answers to these questions at this moment as the agreement signed in June provided a direction but details have yet to be worked out.

Cooperation on Tourism

There is one provision under CEPA that serves as a quick stimuli to Hong Kong's economy - the relaxation of travel policy restrictions for Guangdong residents to Hong Kong. The Mainland will now allow residents in Guangdong Province to visit Hong Kong individually. This measure will be implemented on a trial basis first in three cities and will be extended to the entire Guangdong Province not later than July 1, 2004. Residents of Beijing and Shanghai will be entitled to apply to travel to Hong Kong on an individual basis from September 2003. Under the policy, a maximum of 2,000 people a day from each of the three cities can make solo trips to Hong Kong. Each traveller gets a permit for two private visits within three months. They can stay only for one week and bring up to HK\$5640 (US\$725) each time. Without this new measure, Mainland residents visiting Hong Kong for sightseeing purpose have to join a tour group.

In 2002, the number of mainland visitors reached 6.8 million. The relaxation of travel policy will prompt a huge surge in visitors from China. The number is expected to hit 10 million

next year, according to the Guangdong governor's prediction. He cited evidence of Hong Kong's popularity by saying that the Guangdong government had received 36,000 travel applications in the three days after the scheme was launched.

Based on Hong Kong Tourism Board 2001 statistics, each tourist spent about HK\$4,700, 13.9 percent of which, or HK\$650, was on meals and 1.6 percent, or HK\$74, was on shopping foodstuffs. On average, each tourist spends about HK\$724 on meals and food retail sales. An extra 3.2 million visitors from mainland China to Hong Kong will bring an extra HK\$2 billion (US\$257 million) in restaurant business and HK\$240 million (US\$31 million) in food retail businesses each year. Assuming a 30 percent food cost on restaurant receipts and 65% on retail sales (including profit margins of importers and wholesalers), the total food cost is amounted to HK\$756 million (US\$97 million).

Hong Kong's food supplies rely almost entirely on imports, and the U.S. accounts for roughly 15 percent of total agricultural and food imports. As such, an additional 3.2 million tourists from China can be translated into an extra US\$15 million of U.S. food exports to Hong Kong each year, provided that we can maintain our market share.

Conclusion

Hong Kong has experienced a severe economic downturn in the past few years. CEPA has come into existence with an intention to boost the Hong Kong economy and to expedite closer cooperation between Hong Kong and China in order to enhance development of the Pearl River Delta region. The essence of CEPA is to allow Hong Kong goods and companies to have better access to the China market. All the privileges extended to Hong Kong have the backing of the Mainland Chinese government. While closer cooperation is expected to serve as a catalyst to spur the Hong Kong economy and open up valuable trade opportunities, it also raises concerns that Hong Kong cannot maintain the "one country, two systems" principle.

The trend of further economic integration between Hong Kong and China has gathered full momentum after the signing of CEPA. The agreement adds to the attractiveness of Hong Kong as a springboard to access the China market. U.S. exporters are encouraged to look into the agreement and evaluate how they may capture the new opportunities arising from CEPA. More information about CEPA can be viewed at these websites:

<http://www.tid.gov.hk/english/cepa/index.html>

<http://chamber.org.hk>

(U.S.\$1=HK\$7.8)